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Nos. 87-826, 87-1101

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In the Supreme Court of the United States

OCTOBER TERM, 1988

JEROME F. GOLDBERG and ROBERT MCTIGUE, APPELLANTS

v.

ROGER D. SWEET, DIRECTOR OF THE ILLINOIS DEPARTMENT OF REVENUE, ET AL., APPELLEES.

GTE SPRINT COMMUNICATIONS CORPORATION, APPELLANT

v.

ROGER D. SWEET, DIRECTOR OF THE ILLINOIS DEPARTMENT OF REVENUE, ET AL., APPELLEES.

On Appeal from the Supreme Court of Illinois

SUPPLEMENTAL BRIEF OF APPELLEES PURSUANT TO RULE 35.5

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Appellees Roger D. Sweet, Director of the Illinois Department of Revenue, *et al.*, through their undersigned counsel, respectfully submit this supplemental brief pursuant to Rule 35.5 of the Rules of this Court. The purpose of this brief is to call the Court's attention to a letter dated October 7, 1988, from counsel for the State of Hawaii to counsel for all parties in these consolidated cases. The letter, which is self-explanatory, responds to certain statements regarding Hawaii's tax on interstate telecommunications made in the reply brief of ap-

pellant GTE Sprint in No. 87-1101. It is attached hereto. The subject matter covered in the attached material only recently came to appellees' attention and constitutes intervening matter not available at the time of filing of appellees' brief on the merits. It is therefore a proper subject for a supplemental brief under Rule 35.5.

Respectfully submitted.

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APPENDIX

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APPENDIX

[SEAL]

STATE OF HAWAII

DEPARTMENT OF THE ATTORNEY GENERAL
TAX DIVISION

Room 219
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October 7, 1988

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Re: *Goldberg and GTE Sprint v. Sweet*, Nos. 87-826, 87-1101

Dear Sirs and Madam,

It has come to our attention that the Reply Brief of Appellant GTE Sprint Communications Corporation in

this case filed on August 5, 1988, contains certain incomplete and misleading references to the Hawaiian tax on interstate telecommunications.

On pages 10-12 of its Reply Brief in a section on supposed "realistic alternatives" to the Illinois Tax, GTE Sprint implies that Hawaii has selected a cost-based apportionment formula for each carrier as an alternative to the Illinois system. GTE Sprint suggests that the experience in Hawaii and other states "proves that the actual assessment of taxes, using such alternative formulas, will pose no administrative burden," and that Hawaii's "more sensitive" formula is "superior" to the Illinois method because the Illinois approach is "arbitrary" as compared to those like Hawaii which utilize "economically substantive *indicia*" of instate contributions to interstate calling. Id. at p.12.

The actual situation in Hawaii is substantially different:

1. Hawaii did not choose, and does not want, the complex cost-based carrier-by-carrier apportionment system. In fact, it chose a system virtually identical to Illinois' system, taxing all calls to and from Hawaii charged to a person in Hawaii. Under the Hawaiian statute a backup provision for specific carrier-by-carrier cost-based apportionment is triggered *only if* "under the Constitution and Laws of the United States" the entire amount otherwise taxed cannot lawfully be taxed. See Hawaii Rev. Stat. § 237-13(6); GTE Reply, Appendix E at E-2.

2. Rather than finding the Hawaii alternative "realistic" or of "no administrative burden," in May GTE Sprint's successor, U.S. Sprint, through the same attorney as appears in this case (Mr. Wiley) and later through another attorney (on the very same date as the Reply Brief), *objected* to the proposed Hawaiian apportionment regulations cited in the

brief. They contended that the apportionment system lacked "certainty," depended on "accounting judgments," would "result in greater confusion for our customers and potential difficulty for our company to fully collect the tax," (Wiley letter to Hawaii Director of Taxation, May 20, 1988, attached as Ex. A, at p. 3.), would cause "administrative problems" arising from the "judgment calls and estimates [which] . . . may not accurately reflect the actual costs" and "additional administrative burdens due to the changing costs," and would "contribute to customer confusion," burdens which would trouble both Sprint and the state. (Sprint Testimony before State Department of Taxation, August 5, 1988, attached as Ex. B, at pp. 2-3).

3. Contrary to its position in the Supreme Court criticizing "arbitrary" formulas and preferring "more sensitive" formulas like the fallback option proposed in Hawaii, in fact, in its Hawaii filings, Sprint objected to the actual results of the formula precisely because its sensitivity produced a different apportionment factor for each interstate carrier based on its unique cost structure. Rather Sprint strongly pushed for a single, arbitrarily determined apportionment factor for all the competing companies regardless of their different actual levels of activity in Hawaii, totally eliminating the sensitivity in the original formula because the differences might "disadvantage" some companies and "confuse" customers. Testimony at p. 2. (The single figure suggested was 33.6%).

In short, Hawaii hopes, for many of the same reasons proffered by Sprint in Hawaii, that it will be able to implement fully its Illinois-type tax without having to revert to the complex and prolix rule promulgated as a backup in case the Supreme Court does rule against the equitable and straightforward Illinois system. It is

enough to read the regulation (printed in Appendix F to Sprint's Reply Brief) to understand why this is so. In any event, since Hawaii's rule cannot go into effect until January 1, 1989, that rule is not "experience in other states" supporting such a rule as "superior" to the Illinois approach. The only experience we have had thus far is that Sprint and others say the system is too cumbersome, too burdensome, too confusing, and too sensitive to differences among competitors.

We hope that the counsel arguing the case may have the opportunity to correct the record.

Very truly yours,

/s/ Kevin T. Wakayama
KEVIN T. WAKAYAMA
Supervising Deputy Attorney General
Tax Division

KTW:cm

EXHIBIT A

May 20, 1988

Richard F. Kahle, Jr.
Director of Taxation
State of Hawaii
Department of Taxation
P.O. Box 259
Honolulu, Hawaii 96809

Re: Draft of General Excise Tax Rules on Telecommunication Services

Dear Mr. Kahle:

Thank you for providing US Sprint with the opportunity to comment on the May 10, 1988 draft of the proposed rules for implementing the general excise tax on telecommunications, imposed at Section 237-13(6), Hawaii Revised Statutes, as enacted by H.B. No. 1764-86.

The proposed rule seriously conflicts with the language contained in H.B. No. 1764-86, and with the legislature's intent in passing the legislation. Specifically, the rule seems to violate the intent of the law in the following three areas: 1. It fails to clarify whether the entire gross income from taxable services will be subject to tax; 2. It provides for the use of different apportionment percentages for different carriers if the entire gross income is not subject to tax; and, 3. It uses apportionment criteria which are subject to considerable uncertainty.

With respect to the question whether the entire gross income will be taxed, the draft rule merely restates the language of Section 237-13(6), by providing that "[i]f, under the Constitution and laws of the United States, the entire gross income [received from service which is originated or terminated in this State and is charged to a

telephone number, customer, or account in this State] cannot be included in the measure of tax, such gross income shall be apportioned. . . ." Draft of amended Section 18-237-13(f)(3)(C)(iii) of the Hawaii Administrative Rules. The Department's proposal would essentially leave the long-distance carriers to guess whether or not the tax on their "entire gross income" is required to be reported on their tax returns, and collected from their customers.

The legislation clearly states that "the department of taxation *shall* have determined the amount properly apportioned to the State under Section 237-13(6)", *before* the tax may become effective. *See*, Section 3 of H.B. No. 1764-86 (emphasis added). Further, the Conference Committee Report (No. 68-86, April 18, 1986) stated "[s]ince the general excise tax is a separately stated tax which is customarily passed on to consumers, the Committee concluded that it was appropriate to commence collecting the tax upon the effective date of the Act and not to seek taxes for the period prior to that date." Thus, the legislature intended that the telecommunications carriers know in advance how the tax would be imposed, so that the customary practice of recovering the tax from customers at the time of billing could be accomplished. The proposed rule defeats this legislative intent due to its silence on the fundamental question of whether apportionment will be allowed. We recommend the rule be revised to state whether the tax will apply to the entire gross income.

The rule also diverges from the legal requirement that the apportionment *factor* not differ from carrier to carrier. Section 237-13(6) provides that "*the apportionment factor* and formula *shall be the same* for all persons providing [interstate and foreign telecommunication] services in the State." The Committee on Conference explained that this provision was necessary because "to the extent that different formulas are used, some

companies may be disadvantaged as compared to other companies and customers will be confused by billings at different effective tax rates." Conf. Comm. Rep. No. 68-86, April 18, 1986, at p. 2 (emphasis added). Further, the Committee noted that the aforementioned language had been "modified to clarify its intent that the 'apportionment factor and formula' and not the 'apportionment' of the gross income *shall be the same for all persons providing such service in the State.*" Conf. Com. Rep. at p. 2. Clearly, the legislature was attempting to insure that phone calls would be taxed under the new law at the same *effective* rate, regardless of the carrier used, in order to avoid giving a competitive advantage to companies with comparatively less activity in the State, and to avoid the customer confusion that would result if telecommunications carriers were charging different rates for the tax. For example, a $20 call from Honolulu to New York using Company X might carry a tax of 40 cents ($20 x 50% apportionment factor x 4% tax rate), while the same call using Company Y might bear a tax of only 20 cents (if Company Y's apportionment factor is 25%). We suggest that, in order to conform with the statute, the Department must devise an apportionment formula on an industrywide basis such that the resulting apportionment *factor*, may be applied *equally* to each carrier's gross income.

Finally, the proposed apportionment formula fails to provide telecommunications carriers with any certainty as to what their tax will ultimately be if the Department rules that apportionment is required. For example, the rule requires taxpayers to make accounting judgments in determining the costs of operations directly related to Hawaii, such as the Hawaii proportions of national advertising campaign expenses, national insurance coverage costs, etc. These judgments may be questioned on audit. As a result, taxpayers such as US Sprint will be uncertain as to what the tax will be, and what tax should

be billed to our customers. This will result in greater confusion for our customers and potential difficulty for our company to fully collect the tax.

In summary, the intent of the legislature and the final bill which was passed and subsequently signed by the Governor, envisioned the development by the Department of a single apportionment factor, based upon industry data, which would apply an identical effective tax rate to each carrier, so that no competitive effects or customer confusion would result from the tax. The draft rule does not accomplish this, and we respectfully urge the Department to adopt a rule conforming to the legislative mandate.

We would be happy to provide further comments or respond to any questions you may have.

Very truly yours,

/s/ Richard N. Wiley
RICHARD N. WILEY

/s/ Craig Smith
CRAIG SMITH
Attorneys for US Sprint

EXHIBIT B

U.S. SPRINT COMMUNICATIONS COMPANY

Testimony Before
The State Department of Taxation

August 5, 1988

U.S. Sprint Communications appreciates the opportunity to present comments on the June 21, 1988 draft of the Department of Taxation's proposed rules for implementing the general excise tax on communications. We appreciate the Department's desire to impose the tax in a timely and legally correct fashion and we are anxious to have the apportionment formula resolved in a manner that is both equitable and fair to the industry as well as to the State. However, U.S. Sprint believes the proposed rule has some shortcomings that threaten its equity, neutrality and administrative ease.

The proposed rule fails to comply with the requirement that the apportionment factor not differ from carrier to carrier. Section 237-13(6) provides that "the apportionment factor and formula shall be the same for all persons providing [interstate and foreign telecommunication] services in the State." The Conference Committee Report (No. 68-86, April 18, 1986) explained that this provision is necessary because "to the extent that different formulas are used, some companies may be disadvantaged as compared to other companies and customers will be confused by billings at different effective rates."

The tax is not equitable since it taxes at different effective rates similarly situated taxpayers providing the same services. Failure to provide the same effective rate for all companies and their customers produces a tax that is neither equitable nor neutral.

Further, certain administrative problems will occur for the Department as well as telecommunication com-

panies as a result of the proposed rules. The proposed apportionment formula fails to provide carriers with any certainty as to what their tax will be. The rules require accounting judgments to be made in determining the costs of operations directly related to Hawaii. For example, expenses such as the Hawaii proportions of national advertising campaign expenses and national insurance coverage costs suggest we make estimates. These judgment calls and estimates may be factually incorrect, and may not accurately reflect the actual costs. This process of guessing actual costs will make any audit process more difficult for the Department. As a result taxpayers will be uncertain and confused as to what the tax will be, and what tax should be billed to customers.

Additional administrative burdens exist due to the changing costs of Hawaii and non-Hawaii costs of operations. This proposed rule does not explain whether the companies should compute the factor each month when the returns are due or on an annual basis. If computed on a monthly basis, the changing effective rate will further inhibit companies' ability to accurately pass on the tax, and will further contribute to customer confusion.

These administrative burdens will not only prove difficult for U.S. Sprint and other telecommunication service providers, but also for the State, since the State would have difficulty in projecting future revenues.

Finally, we understand the Department has suggested the industry place a notice on customers' bills which states that the tax complies with Hawaii's 4% general excise tax. We realize this was suggested as a means to resolving some of the industry's concerns about marketing problems and the anti-competitive issues which result from an apportionment formula which is different for each carrier. Unfortunately this will not alleviate our concerns and will only lead to great customer confusion. The apportioned rate would remain unequal for companies, and many customers will notice upon calcula-

tion the differential rates. We believe this problem may be corrected with a minor adjustment to the Department's proposed regulations. This adjustment will be offered as a suggested amendment at the August 5th hearing.

Again, I think you for the opportunity to present U.S. Sprint's concerns. U.S. Sprint stands ready to provide further information to the Department or provide any other assistance requested to aid in the timely development of a fair and equitable apportionment formula.

HAWAII TELECOMMUNICATIONS TAX

Company	Hawaii Costs Related to Hawaii Income / Total Company Costs (Including Hawaii Costs Related to Hawaii Income)	= A Factor x	Hawaii Gross Income Originating or Terminating and Billed to Hawaii	= Hawaii Apportioned Income
Interstate	Per Regulation	40%	$ 15,000,000	$ 6,000,000
Global	Per Regulation	30%	$ 80,000,000	$24,000,000
Multistate	Per Regulation	20%	$ 10,000,000	$ 2,000,000
Instate	Per Regulation	50%	$ 20,000,000	$10,000,000
			$125,000,000	$42,000,000

Composite Weighted Average
($42M/$125M) 33.60%

—The use of a composite weighted average will eliminate marketing pricing differentials, competitive inequities and customer confusion.

—It supports a cost-based allocation mandated by the Hawaii statutes and supported by the Tax Department.

HAWAII TELECOMMUNICATIONS TAX

Company	Hawaii Billed Calls	Apportionment	Apportioned Income	Tax Rate	Tax
DEPARTMENT METHODOLOGY					
Interstate	$15,000,000	40%	$ 6,000,000	4%	$ 240,000
Global	$80,000,000	30%	$24,000,000	4%	$ 960,000
Multistate	$10,000,000	20%	$ 2,000,000	4%	$ 80,000
Instate	$20,000,000	50%	$10,000,000	4%	$ 400,000
					$1,680,000
DEPARTMENT METHODOLOGY/WEIGHTED FORMULA					
Interstate	$15,000,000	33.6%	$ 5,040,000	4%	$ 201,600
Global	$80,000,000	33.6%	$26,880,000	4%	$1,075,200
Multistate	$10,000,000	33.6%	$ 3,360,000	4%	$ 134,400
Instate	$20,000,000	33.6%	$ 6,720,000	4%	$ 268,800
					$1,680,000